



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations

625 Fulton Street, Room 503

Brooklyn, NY 11201

501.03-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

April 2, 2010

Release Number: **201029035**

Release Date: 7/23/10

LEGEND

ORG = Organization name XX = Date

Address = address

ORG

ADDRESS

Taxpayer Identification Number:

Person to Contact:

Identification Number:

Contact Telephone Number:

LAST DATE FOR FILING A PLEADING WITH THE TAX COURT, THE
CLAIMS COURT, OR THE UNITED STATES DISTRICT COURT FOR
THE DISTRICT OF COLUMBIA: July 1, 20XX

CERTIFIED MAIL

Dear

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated May 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s): Organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code are required to operate for charitable, education, or other exempt purposes. Organizations are not operated exclusively for exempt purposes if the net earnings of the organization inure in whole or in part to the benefit of private shareholders or individuals of the organization. See Treas. Reg. section 1.501(c)(3)-1(c)(2).

During 20XX, 20XX, and 20XX we have determined that your net earnings inured to the benefit of your founder through a series of transactions including the appropriation of a government grant, cash withdrawals and personal checks to your founder which were recorded as loans which do not appear to be bona-fide and were not contemporaneously recorded as expenditures of salary or compensation, the payment of auto and other personal expenses of the founder, excessive rental payments to the founder, and reimbursement to the founder for unsubstantiated expenses. The funds inuring to your founder were substantial in comparison to your total assets and activities and were multiple or repeated during the years. You have not implemented safeguards to prevent a recurrence of funds inuring to your founder. As such, you have not operated exclusively for exempt purposes and have operated for the benefit of private

interests of individuals in contravention of the requirements of Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

Contributions to your organization are no longer deductible under IRC §170 after January 1, 20XX.

You are required to file income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the tax year ending December 31, 20XX and for all tax years thereafter in accordance with the instructions of the return.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91st Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

We will notify the appropriate State Officials of this action, as required by Code section 6104(c). You should contact your State officials if you have any questions about how this final determination may affect your State responsibilities and requirements.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Nanette M. Downing
Acting Director, EO Examinations

Enclosure:
Publication 892

Letter 3607(04-2002)
Catalog Number: 34198J

**Internal Revenue Service
Tax Exempt and Government Entities Division
230 S. Dearborn
Chicago, IL 60604**

Department of the Treasury

Date: June 1, 2009

ORG
ADDRESS

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Telephone Number:
Contact Fax Number:

**CERTIFIED MAIL - RETURN RECEIPT
REQUESTED**

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a

petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Sunita Lough
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG EIN:		Year/Period Ended December 31, 20XX December 31, 20XX December 31, 20XX

LEGEND

ORG = Organization name Xx = Date Address = address City = city
State = state CPA = CPA FDN-1 & FDN-2 = 1st & 2nd Founder RA-1 = 1st
RA BM-1 = 1st BM CO-1, CO-2, CO-3, CO-4, CO-5, CO-6, CO-7, CO-8, CO-9
& CO-10 = 1ST, 2ND, 3RD, 4TH, 5TH, 6TH, 7TH, 8TH, 9TH & 10TH COMPANIES

ISSUE:

Whether ORG's tax exempt status under section 501(c)(3) should be revoked because it is not operated exclusively for tax exempt purposes and its net earnings inure to the benefit of its founder, FDN-1.

FACTS:

ORG, (ORG) was recognized as exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code and issued an advance ruling letter in May 19XX. ORG was recognized as a public charity under section 509(a)(2) by letter dated April 23, 20XX. FDN-1 is the President and founder of ORG. The examination was initiated as part of a compliance project to review loans to officers, directors and trustees.

FDN-1 started ORG in January 19XX with 8 children in a leased store front building located at Address, City, State. In 19XX FDN-1 purchased the store front next door located at Address, City, State and in 20XX she purchased both Address and Address, City, State ORG is open from 6:00 am to 6:00 pm and provides services to 108 children, aged 2 through 6 years.

ORG maintains two bank accounts, one at CO-1 in City, State and one at CO-2 in City, State.

INCOME

SOURCES OF FUNDS

ORG reported in its financial statements the following five categories of income.

	20XX	20XX	20XX
INCOME			
Tuition Income			
Program Income			
Income Food			
Income grant			
Other Income			
TOTAL			

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Tuition Income

Tuition income represented fees paid to enable children to attend ORG, with 50 percent private pay and 50 percent paid by State Department of Human Services. Tuition as of July 20XX was \$ per week or \$ per week for children who are not fully potty trained.

Program Income

Program income represented funds received from the Board of Education of the City of City. ORG received two payments of \$ through the Pre- Kindergarten Program to provide services to enhanced services to children enrolled in pre-kindergarten programs for 40 children.

Income Food

ORG received funds as a participant in the Child and Adult Care Food program of the State State Board of Education. The sponsoring organization was CO-3 and copies of the cancelled checks were secured through summons to verify the income (See Exhibit A-1, A-2 and A-3). On a monthly basis a check was issued in the name of both ORG Preschool and FDN-1. CO-3 paid ORG \$ in 20XX, of which FDN-1 deposited \$ into the CO-1 account and \$ into the CO-2 account. Food program checks totaling \$ were not deposited into ORG's accounts, but instead were cashed by FDN-1. In 20XX and 20XX, FDN-1 did not deposit any of the proceeds from the food program, which totaled \$ and \$ respectively, but instead cashed the checks.

FDN-1 stated in an interview on May 11, 20XX, that after she cashed the checks, she took a portion for rent, a portion for utilities and used the rest for food and other bills. No documentation, such as receipts or a log, were provided as to how the cash was expended. The total amounts of the cashed checks were entered into ORG's general ledger as income at the end of each year as "Cash per FDN-1."

Income Grant

In 20XX, ORG received a grant of \$ from the State Department of Commerce and Community Affairs. The purpose of the grant was for expenses associated with the expansion of the child care facility. The grant paperwork indicates that ORG stated that FDN-1 would cover expansion costs in excess of \$ out of pocket. The close out paperwork for the grant states that approximately \$ in local funds was expended in excess of the \$ grant. The grant period was from July 1, 20XX to June 30, 20XX. The grant payment was received by ORG in August 20XX, and deposited into the CO-2 account on August 18, 20XX. On August 31, 20XX, check number was written to FDN-1 for \$. (See Exhibit B) The amount was not reported as compensation to FDN-1.

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ORG also took out a \$ loan in 20XX to pay for the same expansion (further discussed below). ORG provided a list of expenditures alleged to be related to the expansion of the daycare during 20XX and alleged the expenses totaled in excess of \$. Invoices and accepted contractor proposals for some but not all of the expenditures were provided. Documentation of payment was provided for a few of the invoices and proposals. Copies of money orders drafted from CO-1 on cash were provided as evidence of payment.

Copies of personal checks for and a money order drawn on FDN-1's personal bank accounts to the order of RA-1 for plumbing work for ORG's expansion were provided as follows:

Check # (CO-4)	4/13/XX	\$
Check # (CO-1)	5/10/XX	\$\$
Check # (CO-1)	5/20/XX	\$\$
Check # (CO-1)	7/8/XX	\$\$
Check # (CO-1)	7/16/XX	\$\$
M.O. # (on CO-1 account)	5/15/XX	\$\$
Total:		\$\$

EXPENSES

USE OF FUNDS

ORG's expenses were analyzed as a part of the determination as to whether ORG was operating exclusively for a tax-exempt purpose. The expense accounts were reviewed and the following expenditures do not appear to have been made in furtherance of ORG's exempt purposes.

Auto Loan Payments

FDN-1 entered into a sales agreement on November 8, 20XX with CO-5 to purchase a 20XX GMC Denali for \$\$\$. The purchase was to be financed, with the financed price being \$ and 72 monthly payments of \$. The sales tax transaction return asks, "Is the sale exempt from tax," and includes a space to indicate that the car was sold to an exempt organization, which is not indicated. During the calendar years 20XX, 20XX and 20XX, ORG made the monthly payments and paid out \$ in 20XX, \$ in 20XX and \$ in 20XX. (See Exhibit C-1, C-2 and C-3)

Documentation of business use for 20XX, 20XX and 20XX consisted of a brief, handwritten list of each month of the year with a statement that between \$ to \$ was spend per week for gas and between 20-30 miles were driven per week. (See Exhibit C-4, C-5 and C-6) No mileage log was provided with specific dates, miles driven, and locations of travel, no receipts were provided and

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no business purpose for the use of the vehicle was provided. The amounts were not reported as compensation to FDN-1.

Excess Rental Payments

ORG entered into a commercial lease agreement with FDN-1 for four years commencing on August 1, 20XX and ending August 1, 20XX. The property rented was Address. According to the lease, "annual" rent was to be \$. (See Exhibit D-1) ORG entered into a subsequent rent starting September 1, 20XX. According to the lease, "annual" rent was to be \$. There was no appraisal of the fair market value of the rental but ORG provided a letter from a development company that a building in the neighborhood which was 3,910 square feet would rent for \$ per month (\$ per square feet). (See Exhibit D-2, D-3)

The actual payments recorded as rent in the general ledger totaled \$ in 20XX, \$ in 20XX and \$ in 20XX. (See exhibit D-4, D-5, and D-6) No Forms 1099-MISC were issued to FDN-1 to report the rental income. FDN-1 reported rental income of \$ per year on her personal Forms 1040 for 20XX, 20XX and 20XX, which is the equivalent of \$ monthly rent.

State Facility Fund Loan

In 20XX, ORG granted a mortgage to the State Facilities Fund for \$, also for the purpose of expanding the day care. According to the agreement the monthly payment was \$ and the loan term was five years. The purpose of the loan was to make improvements to the day care facilities. ORG made payments toward the loan of \$\$ in 20XX, \$\$ in 20XX and \$\$ in 20XX. (See exhibit E-1, E-2 and E-3). It is unknown how the original loan proceeds were used by ORG.

Leasehold Improvements

ORG's general ledger for 20XX shows expenses for leasehold improvements totaling \$\$ (See Exhibit F-1) ORG's Form 990 for the 20XX year shows capitalized expenses of \$\$ for windows. ORG made payments totaling \$\$ to CO-6. ORG also made a payment of \$\$ to FDN-1 by a check with a memo line reading "Reimbursement for new windows."

ORG provided a proposal to ORG from CO-6 proposing to install new windows and doors at a total cost of \$. The proposal is signed by FDN-1 with a note "Date to Start – April 9, 20XX." No further documentation of the cost was provided, nor was any explanation of the excess reimbursement to FDN-1 in the amount of \$ (Agreed cost per accepted proposal less the amount paid by ORG less the balance of agreed cost). The excess amount was not reported as compensation to FDN-1.

Credit Card payments

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ORG had credit cards with CO-7 and CO-8. FDN-1 stated in a May 11, 20XX interview that the CO-7 card was used for preschool materials and the CO-8 card was used for pre-school items and 20XX expenses. ORG provided no documentation that the balances represented day care expenditures.

ORG provided statements for the 20XX year only. The beginning balance for January 20XX for CO-7 was \$ which represented purchases only and the ending balance in December 20XX was \$. The beginning balance for January 20XX for CO-8 was \$ which included purchases and cash advances, and the ending balance in December 20XX was \$. The statements show that the balances were only negligibly reduced due to finance charges, late fees, and over limit fees. ORG made payments totaling \$ in 20XX, \$ in 20XX, and \$ in 20XX to CO-7. ORG made payments totaling to CO-8 \$ in 20XX, \$ in 20XX and \$ in 20XX. (See Exhibit G-1, G-2 and G-3).

Unsubstantiated expenses

All of the expense accounts of the general ledger were reviewed for 20XX, 20XX and 20XX. Checks written to FDN-1 as payee were noted in the ledger accounts of program expense, professional fees, supplies, fundraising expense, repairs & maintenance, food and miscellaneous. (See Exhibit H-1, H-2 and H-3) In 20XX the amount totaled \$; in 20XX the amount totaled \$; and in 20XX the amount totaled \$. Most of the checks were written for amounts in even multiples of \$. No documentation, such as receipts, were provided as to the business purpose of the expenditures. The amounts were not reported as compensation to FDN-1.

Checks included General Ledger under Officer Salary

The ledger account for officer salary, account 601 was reviewed. Check # dated March 1, 20XX was written to the order of FDN-1 for \$ with "Administrative General" entered into the general ledger. Check # dated September 12, 20XX was written to the order of CO-9, apparently a home mortgage company, for \$ with "CO-9 for FDN-1" noted on the general ledger. Officer payroll of \$ was transferred from salary account to officer salary account. FDN-1 was issued a Form W-2 for wages of \$ and the other officer FDN-2 was issued a Form W-2 for wages of \$.

The checks in the amounts of \$ and \$ were not included as wages on Form W-2. The initial Form 990 filed with the Ogden Service Center June 26, 20XX, Part V-A Current Officers, Directors, Trustees, and Key Employee reported compensation for FDN-1 of \$. The amended Form 990 received by the Ogden Service Center October 1, 20XX, Part V-A reported compensation for FDN-1 of \$. No Forms 1099-MISC were filed by ORG. There were no records that authorized the additional salary to FDN-1.

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BALANCE SHEET

ASSETS

Account Receivable

The Forms 990 reported the accounts receivable from officers as follows:

12/31/XX		12/31/XX		12/31/XX		12/31/XX	
Beginning Balance	Ending Balance	Beginning Balance	Ending Balance	Beginning Balance	Ending Balance	Beginning Balance	Ending Balance

The beginning balance for the 20XX year Form 990 was \$, while the ending balance was \$. The accounts receivable balance comprised 63% of the total assets reported on ORG's 20XX Form 990, 31% in 20XX (the first time that the balance was zeroed out), 69% in 20XX, and 72% in 20XX.

The accounts receivable account in the general ledger contained cash withdrawals from ORG's two checking accounts and checks written to or on behalf of FDN-1. CPA, a CPA who provided accounting services for ORG since the organization began, was interviewed by telephone on April 24, 20XX. CPA stated the accounts receivable were funds spent for personal purposes by FDN-1 and that she told FDN-1 she had to pay it back.

The Bank account statements from the business checking account at CO-1 were reviewed and cash withdrawals were noted. The withdrawals were made at the CO-10 in City, State and several ATM locations in City, State and the south City area. Total withdrawals made were \$\$ in 20XX, \$\$ in 20XX and \$\$ in 20XX. (See Exhibits I-1, I-2 and I-3)

The Bank account statements for the business checking account at CO-2 were reviewed and cash withdrawals were also noted. Total withdrawals were made at several ATM locations and at the CO-10 in City, State of \$ in 20XX. (See Exhibit I-4)

Nearly all of the cash withdrawals were in round hundred dollar amounts such as \$ or \$. The round hundred dollar amounts were reported as accounts receivable from FDN-1, while the related bank fees appear to have been charged as an expense to the Organization.

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In addition, checks were written to or on behalf of FDN-1 and recorded as accounts receivable in the general ledger which totaled \$\$ in 20XX; \$\$in 20XX; and \$\$ in 20XX. Many of the checks were written for amounts in even multiples of \$. (See Exhibit J-1, J-2 and J-3) The memo lines for a few checks state purposes including bonus, supplies, administrative, and loan repayment; however, no documentation such as receipts was provided as to the purpose of the expenditures.

ORG provided a copy of board meeting minutes dated December 11, 20XX, which include the statement, "FDN-1 mention that hopefully she could see some reimbursement of her personal funds from when she started the company and the two expansion one in 19XX and 20XX. Every one agreed that maybe I should start some type of repayment from the company. FDN-1 stated I will look into it [sic]. ORG also provided a copy of board meeting minutes dated June 12, 20XX, which stated that FDN-1 requested that the board approve "some type of repayment plan for reimbursement for my private funds from when the company first started. BM-1 asked how do you want to go ahead with it. I like to start at least some cash withdrawals. I've thought about it and this is the way I would prefer to do it. Its okay just keep track of cash disbursements." [sic]. No further board meeting minutes discussing this issue were provided.

There were no promissory notes, terms of repayment, interest charged, or balance approved by the board for amounts purportedly loaned to ORG by FDN-1. In 20XX, ORG's attorney provided a list of expenses totaling over \$ and an \$ deposit into ORG's account between 19XX and 19XX, all allegedly paid by FDN-1 on ORG's behalf. However, only one invoice and no proof of payment by FDN-1 was provided.

LIABILITIES

Neither the Forms 990 nor the general ledger report any loans payable to FDN-1.

EXCESS BENEFIT TRANSACTIONS

Based on the above described transactions between FDN-1 and ORG, the Service is asserting that section 4958 excise taxes are proposes against FDN-1 in the following amounts:

	20XX	20XX	20XX
WITHDRAWALS FROM BANK ACCOUNTS			
CO-1	\$	\$	\$
CO-2	-		
AUTO LOAN PAYMENTS			

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RENT PAID IN EXCESS OF LEASE AGREEMENT			
LEASEHOLD IMPROVEMENTS			
GRANT FUNDS DIVERTED TO EXECUTIVE DIRECTOR			
CHECKS WRITTEN TO OR ON BEHALF DIRECTOR AND REPORTED AS RECEIVABLES			
CHECKS WRITTEN TO DIRECTOR-UNSUBSTANTIATED EXPENSES			
PAYMENTS RECORDED AS OFFICER SALARY-NOT TREATED AS COMPENSATION			
TOTAL			

LAW:

Internal Revenue Code section 501(c)(3) exempts from Federal income tax: corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Treasury Regulation section 1.501(a)-1(c) defines a private shareholder or individual for section 501 purposes as those persons having a personal and private interest in the activities of the organization.

Treasury Regulation section 1.501(c)(3)-1(a)(1) provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Treasury Regulation section 1.501(c)(3)-1(b)(1) states that an organization is organized exclusively for one or more exempt purposes only if its articles of organization (a) limit

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the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Treasury Regulation section 1.501(c)(3)-1(c)(1) states that an organization will be regarded as “operated exclusively” for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treasury Regulation section 1.501(c)(3)-1(c)(2) states, in part, that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Treasury Regulation section 1.501(c)(3)-1(d)(1)(i) provides that an organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

- (a) Religious,
- (b) Charitable,
- (c) Scientific,
- (d) Testing for public safety,
- (e) Literary,
- (f) Educational, or
- (g) Prevention of cruelty to children or animals.

Treasury Regulation section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Fact patterns suggesting inurement also frequently suggest excess benefit transactions between an exempt organization and a disqualified person under § 4958. The recent regulations issued under § 501(c)(3), at Treas. Reg. § 1.501(c)(3)-1(f)(ii), instruct the Service to consider a variety of factors to determine whether revocation is appropriate when section 4958 excise taxes also apply:

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- (A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
- (B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
- (C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;
- (D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and
- (E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction

The Commissioner has discretion to weight the factors depending on the particular situation, but the latter two factors are weighted heavier only when the Organization has taken preemptive steps to correct the excess benefit transaction before they were brought to the Commissioner's attention. Treas. Reg. § 1.501(c)(3)-1(f)(iii).

Treas. Reg. § 1.501(c)(3)-1(f)(iv) Example 3 supposes that an organization's founder diverts significant portions of the organization's to pay personal expenses, which reduces the funds available to conduct exempt activity, over the course of multiple years. The board of trustees never authorized the organization to pay the founder's personal expenses and takes no action to seek repayment or terminate the founder's involvement with the organization. The founder claims that the payments represent loans, but no contemporaneous documentation exists and no payments of principal or interest were ever made to the organization. Based on the factors above, the regulations contemplate that not only does the diversion of funds constitute an excess benefit transaction under § 4958, but the prohibition against inurement has been violated and the organization no longer qualified as an organization described in § 501(c)(3).

Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe.

Section 6033(a)(1) of the Code provides, except as provided in section 6033(a)(2), every organization exempt from tax under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of carrying out the Internal Revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

Section 1.6001-1(a) of the regulations in conjunction with section 1.6001-1(c) provides that every organization exempt from tax under section 501(a) of the Code and subject to the tax

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imposed by section 511 on its unrelated business income must keep such permanent books or accounts or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax. Such organization shall also keep such books and records as are required to substantiate the information required by section 6033.

Section 1.6001-1(e) of the regulations states that the books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained as long as the contents thereof may be material in the administration of any internal revenue law.

In accordance with the above cited provisions of the Internal Revenue Code and Treasury Regulations under sections 6001 and 6033, organizations recognized as exempt from federal income tax must meet certain reporting requirements. These requirements relate to the filing of a complete and accurate annual information (and other required federal tax forms) and the retention of records sufficient to determine whether such entity is operated for the purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax.

Rev. Rul. 59-95, 1959-1 C.B. 627, concerns an exempt organization that was requested to produce a financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provisions of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

In Better Bus. Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that for an organization to qualify for tax exempt status, the organization must be exclusively devoted to an exempt purpose and the presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.

Where an individual or small group has exclusive control over the management of the organization's funds and is the principle recipient of the distributions of the organization, prohibited inurement is strongly suggested. See Church of Enternal Life & Liberty v. Commissioner, 86 T.C. 916, 927 (1986);

In Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970), an organization argued that the Court should not find that

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the organization's earnings inured to its founders since it had made some payments to him as repayments on a loan. The organization could not, however, produce any documents evidencing the indebtedness. The Court concluded that the church had failed to meet its burden of proof that a part of the corporate earnings was not a source of benefit to private individuals.

In John Marshall Law School v. United States, 228 Ct. Cl. 902 (1981), the law school and the college paid for the founding family's automobiles, education, travel, expenses, insurance policies, and personal equipment. The court determined that the expenditures for the founding family were not ordinary and necessary expenses in the course of the law school's and the college's operations. The court also held that the payment of such personal expenses for the founder's children by the law school provided direct and substantial benefit to the founder of the law school and his brother. The court held that these payments constituted prohibited inurement of the law school's earnings to the founder and his brother, parents of the children receiving the benefits.

In Greg R. Vinikoor v. Commissioner, T.C. Memo. 1998-152, the Tax Court held that whether a financial transaction constitutes a loan depends on all the facts and circumstances, including whether (1) there was a promissory note or other evidence of indebtedness; (2) interest was charged; (3) there was security or collateral; (4) there was a fixed maturity date; (5) a demand for repayment was made; (6) any actual repayment was made; (7) the transferee had the ability to repay; (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and (9) the manner in which the transaction was reported for Federal tax purposes.

In Rameses School of San Antonio, Texas v. Commissioner, T.C. Memo 2007-85, the Tax Court held that a private school failed to qualify for exemption under section 501(c)(3) because it operated for the private benefit of its founder. The Tax Court stated: Factors highlighted of a prohibited relationship have included control by the founder over the entity's funds, assets, and disbursements; use of entity moneys for personal expenses; payments of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts; and purported loans to the founder showing a ready private source of credit. Nearly all of these factors are present here.

GOVERNMENT'S POSITION:

The IRC 501(c)(3) tax exempt status of ORG (the "Organization") should be revoked because it is not operated exclusively for tax exempt purposes. An organization described in section 501(c)(3) must establish that no more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Treas. Regs. 1.501(c)(3)-1(c)(1).

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FDN-1 is an officer, director, and a "private shareholder or individual" because she is a "person having a personal and private interest in the activities of the organization." as defined in §1.501(a)-1(c) cited above. She is the founder and executive Director of ORG. FDN-1 has sole control over the income, disbursements and assets of the Organization.

FDN-1 diverted ORG's funds for her personal benefit as illustrated by the transactions described above. FDN-1 diverted \$ in grant funds in 20XX to herself, purportedly for repayment of funds she claimed to have expended on the 20XX expansion of the day care facilities. Documentation of only \$ in expenditures made from FDN-1's personal account was provided. The remaining \$ was not shown to be expended for the ordinary and necessary expenses of the day care operations. No mention of the \$ in loan proceeds for the expansion received from the State Facilities fund has occurred in FDN-1's claims regarding her claims that she expended personal funds for ORG's expansion.

As a matter of practice FDN-1 regularly cashed the checks from the food program, instead of depositing them into ORG's general accounts. According to her statement in a May 11, 20XX interview, a portion was used for rent, a portion for utilities, and the rest for food and other bills. A single journal entry at the end of each year recorded the amounts as income to ORG as cash "per A FDN-1." No documentation of how the cash was expended was provided.

FDN-1 regularly used ORG's funds to pay rent in excess of the \$ per month owned under the lease agreement, which she caused ORG to enter into with herself, often times paying herself \$ per month. FDN-1 also used the Organization's funds to pay herself reimbursement \$ in excess of the documented cost of installing new windows for ORG.

FDN-1 frequently wrote checks to herself for expenses for which there is no documentation to show they were day care related expenditures. The checks are almost always written in even multiples of \$ which does not give the impression that the reimbursements corresponded to genuine expenses of ORG.

FDN-1 also expended the Organization funds for non exempt purposes, including paying her personal expenses. She used Organization funds to pay the monthly auto loan for her personal automobile, and there was no documentation of any business use of the vehicle. Two checks totaling \$ including one which appears to be a personal mortgage payment, were written to and for the benefit of FDN-1 in 20XX, recorded as salary in the ledger and not included as wages in Form W-2.

FDN-1 used ORG's assets for her personal purposes. According to the prior accountant, she had advised FDN-1 to repay the Organization all accounts receivable funds used for personal purposes. The hundreds of thousands of dollars recorded as accounts receivable included

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repeated cash withdrawals, many at a nearby casino, and checks written to and for the benefit of FDN-1. These checks appear similar to the unsubstantiated expenses checks to FDN-1, both in the types of notations in the memo lines and the fact that many are for amounts in even multiples of \$\$.

The Forms 990 show the accounts receivable balance owed from FDN-1 being zeroed out twice between 20XX and 20XX. A \$ accounts receivable on December 31, 20XX became \$ in January 20XX; and a \$ accounts receivable on December 31, 20XX, became \$ in January in 20XX.

There is no internal control to ensure that funds were used for exempt purposes. FDN-1 had free reign over the following:

- to deposit the income or not deposit the income;
- pay the note on her personal vehicle;
- establish rent to be paid to herself then pay herself more;
- use ORG's credit cards; write checks for salary then not report on Form W-2;
- make cash withdrawals at any time;
- write checks to herself with no documentation required;
- and amount up receivables to ORG that disappear into thin air

There is no record that the Board members questioned FDN-1's control the funds. It appears they allowed her to spend ORG's funds however she wished and were "yes" people who went along with FDN-1's wishes to repay herself without question.

Analysis under the factors laid out in Treas. Reg § 1.501(c)(3)-1(f) supports the conclusion that revocation of the Organization's exempt status is appropriate in this case. Excise taxes under I.R.C. § 4958 are concurrently proposed against FDN-1 in her capacity as a disqualified person with regards to ORG and the same transactions described above. The situation is very similar to Example 3 of the regulation. The funds available for the organization's activities before and after the transactions appears to have affected. FDN-1 diverted thousands of dollars in cash withdrawals and payments of personal expenses from ORG, yet only caused ORG to make the minimum payments on its outstanding credit card balances. Over \$ in food program funds were received by ORG, yet instead of depositing the funds in ORG's accounts, FDN-1 cashed them kept no records of how the funds were spent. The size and scope of the transactions are substantial in relation to ORG's exempt activities. The relative size of the total accounts owed by FDN-1 to the Organization's total assets, as reported on ORG's Forms 990, also weighs heavily against Organization's continued exempt status.

The excess benefit transactions between FDN-1 and ORG multiplied and repeated during the years at issue. No loan documentation exists, nor is FDN-1 known to have made any payments of principle

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or interest on the amounts recorded as accounts receivable. There were no internal controls in place, the board did not question FDN-1's management of ORG's funds, and no safeguards were put in place to prevent the occurrence of excess benefit transactions. No correction known to have been sought by or made to ORG, although the accounts receivable balances were twice zeroed out on ORG's forms 990, despite no evidence of repayment by FDN-1.

In summary, FDN-1 operated ORG more like a personal business than an exempt organization. FDN-1 had control over ORG's funds, assets and disbursements; made use of the funds for personal use; and made repayments for purported loans she made to the Organization for which there was no documentation. FDN-1 essentially appears to have had access to a zero interest line of credit with no promissory notes, terms of repayment, interest charged, or balance approved by an informed board of directors for purported loans between ORG and FDN-1. The income and assets of ORG inured to the benefit of FDN-1 the founder and President of the Organization, thus ORG was not operating exclusively for exempt purposes as required by section 501(c)(3). See Rameses School of San Antonio, Texas v. Commissioner, T.C. Memo 20XX-85.

TAXPAYER'S POSITION:

In a letter dated September 6, 20XX, ORG's attorney provided the following positions with regard to the GMC automobile, rental payments and the accounts receivable.

- The truck was purchased for use by the ORG.
- The rental payments under the lease are \$ per month, and the rental payments have been substantially lower than market price in the area.
- The amounts reflected as accounts payable and distributed to FDN-1 are repayment of the loans advanced by her during ORG's formative years, but had not been properly reported.
- An outside audit for the 20XX year showed that no funds were taken out by FDN-1 during that year.

REBUTTAL TO TAXPAYER'S POSITION

The taxpayer has provided no documentation that the truck was purchased for use by ORG.

FDN-1 only reported the amount under the lease as rental income on her personal Forms 1040 for the years at issue. In addition, FDN-1 signed the lease with ORG both as a representative of ORG as lessee and in her individual capacity as lessor. Presumably, FDN-1 had complete control over the terms of the lease.

There is no contemporaneous documentation that FDN-1 made any loans or paid any of ORG expenses, apart from personal checks and a money order, totaling \$ paid to a plumber for ORG's expansion in 20XX. No promissory notes, records of interest accrued, terms of repayment, or

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other documentation that bona fide loans were transacted between ORG and FDN-1 was provided. Neither ORG's general ledger nor its Forms 990 show any loans payable to FDN-1.

Many of the claimed expenses were purportedly paid from 19XX to 19XX, yet no financial information has been provided for years prior to 20XX to document that FDN-1 has not previously been repaid or taken funds to repay herself for these claimed expenses. The 20XX outside audit figures do not match the Accounts Receivable figures reported on the Forms 990 for 20XX and 20XX. In addition, the accountant who performed the audit appears to have had his license suspended at the time for conspiracy to defraud the United States by impeding the Internal Revenue Service.

In summary, the cash withdrawals by FDN-1, the payments to FDN-1 recorded as accounts receivable, and other payments to or for FDN-1's benefit as purported reimbursements for unsubstantiated business expenses are amounts which inured to the benefit of FDN-1 and also constitute excess benefit transactions within the meaning of Internal Revenue Code section 4958. Analysis under Treas. Reg. § 1.503(c)(3)-1(f) demonstrates why revocation is appropriate in addition to the section 4958 excise taxes. See also Greg R. Vinikoor v. Commissioner, T.C. Memo. 19XX-152 and Foundling Church of Scientology v. United States, 412 F.2d 1197, (Ct. Cl. 1969).

CONCLUSION:

Accordingly, the Organization's status as an organization described under section 501(c)(3) should be revoked, effective January 1, 20XX, because it did not operate exclusively for exempt purposes. Instead, ORG's assets inured to and served the private interests of its founder FDN-1. Further, the Organization failed to comply with IRC 6001 and 6033 and has not established that it is observing the conditions required for the continuation of exempt status. Form 1120 U.S. Corporate Income Tax Return should be filed for tax years ending December 31, 20XX through December 31, 20XX.